BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

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In the Matter of the Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Los Angeles District to increase revenues by $2,020,466 or 10.88% in the year 2007; $634,659 or 3.08% in the year 2008; and $666,422 or 3.14% in the year 2009	A.06-01-005

COMMENTS OF CALIFORNIA-AMERICAN WATER COMPANY ON THE PROPOSED DECISION OF ADMINISTRATIVE LAW JUDGE WALWYN

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I. INTRODUCTION

In accordance with Rule 14.3 of the California Public Utilities Commission ("CPUC") Rules of Practice and Procedure, California-American Water Company ("California American Water") hereby submits its comments on the Proposed Decision of Administrative Law Judge Walwyn, mailed May 7, 2007 ("PD"). Although California American Water is pleased that the PD properly adopted the partial settlement agreement between California American Water and the Division of Ratepayer Advocates ("DRA"), the PD is still seriously deficient in material respects on several significant issues. As discussed in more detail below, several of the rulings set forth in the PD are inequitable, unreasonable, unsupported by the record evidence and contrary to expressed CPUC goals and precedent.

In these comments California American Water will address (1) the erroneous and premature reduction of the return on equity ("ROE") tied to the implementation of a water revenue adjustment mechanism ("WRAM"), (2) the flawed ROE analysis and rejection of a leverage adjustment for California American Water, and (3) the self-defeating and unnecessary restrictions on the Infrastructure System Replacement Surcharge ("ISRS") program. California American Water urges the CPUC to modify the PD as discussed below. Pursuant to Rule

14.3(b), California American Water's proposed findings of fact and conclusions of law are attached as Appendix A.

II. THE RULING ON THE ROE REDUCTION LINKED TO THE WRAM IS ERRONEOUS AND PREMATURE

A. The Ruling on the ROE Reduction is Premature

The PD's ruling that the imposition of a WRAM in the second phase of this proceeding would warrant a substantial ROE reduction rashly prejudges the issue. The PD makes significant assumptions concerning the impact of a WRAM and modified cost balancing account ("MCBA"), even though these regulatory mechanisms have not yet been reviewed in this proceeding. Additionally, the record evidence on this issue is scant at best and was produced in haste. Finally, this issue is more appropriately reviewed in other CPUC proceedings, which will provide the opportunity to vet the issues more thoroughly, rather than making a sweeping policy decision in a vacuum.

1. The PD Improperly Judges the Impact of Regulatory Mechanisms that Have Not Been Fully Developed or Reviewed

The PD errs in ruling on the impact of a WRAM (and to a lesser extent a MCBA) before the record on these mechanisms has been developed. The May 22, 2006 *Assigned Commissioner's Scoping Memo and Ruling* ("Scoping Memo") bifurcated this proceeding into two phases: the first to address California American Water's revenue requirement, the second to address the rate design.[1] Both the WRAM and the MCBA are rate design issues. At the January 9, 2007 evidentiary hearing, the ALJ ruled that the issuance of a CPUC decision on the revenue requirement will signal the completion of the first phase and trigger the rate design phase.[2] By doing so, the ALJ recognized that the record is not yet fully developed regarding the WRAM and the MCBA. The lack of evidence on the record concerning these mechanisms, however, did not stop the PD from making sweeping statements about their alleged impact on California

[1] Scoping Memo, p. 7.
[2] RT 915:5-24 (Walwyn, Dolqueist (CAW)).

American Water. It would be a legal error for the CPUC to adopt a decision that judges the impact of the WRAM and MCBA before the mechanisms themselves have been finalized and scrutinized.

2. The Information on the Record Concerning the Impact of the WRAM is Scant and Was Produced in Haste

Even if it were possible to analyze the impact of the WRAM and the MCBA before the mechanisms themselves were fully developed and reviewed, such an analysis certainly did not take place in this proceeding. What little information there is on the record concerning the issue of a reduction in ROE for the WRAM was produced in less than two weeks, with little or no opportunity for discovery or cross-examination.

Although DRA addressed the issue of the reduction in ROE for the WRAM very briefly in its *Report on the Cost of Capital,*[3] it was not truly raised until the ALJ brought it up at the June 15, 2006 evidentiary hearing. At the hearing, the ALJ, noting that DRA had not analyzed exactly how the WRAM would change California American Water's risk,[4] and then ordered DRA to produce such an analysis within one week. The ALJ provided five days for California American Water to review DRA's analysis and provide rebuttal testimony. The evidentiary hearing on this issue was held on June 28, 2006, the day after California American Water issued its rebuttal testimony.[5] This two-week whirlwind was hardly sufficient to analyze and review such a complex and important regulatory issue.

If the CPUC adopts the PD, it will be the first decision concerning the question of whether or not there is an impact of a conservation rate design WRAM on a water utility's ROE. Not only will it have a significant financial impact on California American Water, it will also have a significant impact on all CPUC-regulated water utilities, because it will likely serve as a model as other utilities adopt WRAMs. The CPUC should not base a decision of this magnitude

[3] Exh. 37, p. 3-2.
[4] RT 508:2-6 (Walwyn).
[5] RT 580: 16-21 (Walwyn).

on a negligible evidentiary record that was hastily produced in a two-week period.

3. This is Not the Proper Proceeding to Address the ROE Reduction for a WRAM

Not only is it improper to judge the impact of an as-yet unfinalized WRAM on California American Water's ROE based on a hurriedly produced and inadequate evidentiary record, its inappropriate to make such a sweeping policy decision in the general rate case of a single water utility. As noted above, this is a case of first impression with far-reaching policy implications for the entire water industry. This type of policy issue should be addressed in a generic proceeding that allows the participation of other water utilities and interested parties. Indeed, there is one pending proceeding and one upcoming proceeding that provide more appropriate venues for the CPUC to vet this issue than the current proceeding.

The first proceeding is the CPUC's proceeding on conservation objectives for Class A water utilities.[6] The Conservation OII proceeding is a generic proceeding that addresses policy issues related to conservation rate design and conservation programs, as well as the specific rate designs and programs of certain Class A water utilities. It is much more appropriate to address this issue in the Conservation OII proceeding, in which all Class A water utilities are participants, than in California American Water's rate case proceeding.

The second proceeding is the upcoming combined cost of capital proceeding for the three largest water utilities. On May 24, 2007, the CPUC adopted a new rate case plan for water utilities, which orders the three multi-district class A water utilities[7] to file a separate cost of capital applications in May 2008. These applications will be consolidated into a single proceeding that will examine cost of capital issues in more depth than is normally allowed in a general rate case. This cost of capital proceeding presents the opportunity to conduct a full review and analysis of whether a reduction in ROE due to a conservation rate design WRAM is justified and will enable the parties to assess this issue in the context of other regulatory,

[6] I.07-01-022 ("Conservation OII").
[7] California American Water, California Water Services, and Golden State Water.

business, and financial risks. Moreover, this proceeding will have the added benefit of financial market information that post-dates the implementation of WRAM. Rather than prematurely decide the issue of the ROE reduction now, the interest of all parties would be better served if the CPUC were to defer the issue to the upcoming cost of capital proceeding.

B. Reducing the ROE Because of the WRAM is Incorrect and Unsupported by the Record

Even assuming for the sake of argument that this proceeding is indeed the correct place to address the issue of whether a conservation rate design WRAM justifies a ROE reduction, the conclusions reached by the PD are incorrect and unsupported by the record. First, the PD overstates potential for the WRAM to reduce California American Water's regulatory and business risk. Second, the PD's own preferred return on equity methodology shows that the investment markets will adjust for the WRAM, if they consider it to be relevant at all. Third, the PD mischaracterizes CPUC precedent, which does not support the ROE reduction for the WRAM. Finally, reducing the ROE of a utility based on implementation of a conservation rate design WRAM creates a strong disincentive for that utility to pursue conservation aggressively, which is contrary to the CPUC's stated goals and policies.

1. The PD Exaggerates the Risks Reduced by the WRAM

The PD's risk assessment substantially overstates the WRAM's risk reduction potential. The PD fails to recognize that before the risks are reduced by the WRAM and MCBA, they will be increased by the conservation rate design. The PD also fails to consider the ways in which the WRAM limits California American Water's revenue potential and provides benefits to customers. Finally, the PD ignores the significant risks that remain despite implementation of a WRAM. Once these errors have been corrected, there is no justification for a ROE reduction.

a. Conservation Rate Design <u>Increases</u> California American Water's Risk

The WRAM and MCBA do not reduce California American Water's current level of risk. Rather, California American Water's current level of risk will be increased by the conservation rate design under consideration in the second phase of this proceeding, and the

purpose of the WRAM and MCBA is to offset those risks. The WRAM and MCBA do not necessarily provide California American Water an added benefit of risk reduction; rather they serve to mitigate the increased risk associated with conservation based rate design.

As the PD recognizes, the proposed conservation rate design will increase California American Water's business risk. The PD states, "There is also increased sales uncertainty as the CPUC implements its higher levels of conservation under the Water Action Plan."[8] The PD also notes, "The conservation rate design being considered in Phase 2 will shift more fixed cost recovery onto the commodity rates, thereby increasing Cal-Am's business risk under existing ratemaking mechanisms."[9] The purpose of the WRAM and the MCBA is to offset these risks and bring California American Water back to (but not necessarily above) its current pre-conservation rate design level of risk. The PD errs because although its language recognizes California American Water's increased risks, its ROE reduction calculation does not take the risk increase into consideration.

b. The PD Fails to Recognize the Risk Reduction for Customers

The PD also errs by not taking into account the symmetrical nature of the WRAM and MCBA. In addition to offsetting the increased risk due to the imposition of an increasing block rate design for California American Water, the WRAM and MCBA offsets the customer risk of paying more than the authorized revenue requirement. For example, customers currently have little protection against a utility earning more than its authorized return. The WRAM, however, which is linked to the utility's revenue requirement and authorized rate of return, significantly reduces the risk to customers that the utility will be able to over-earn.[10] This side of the WRAM could conceivably be interpreted negatively by investors, offsetting other utility benefits of the WRAM. Additionally, the MCBA removes the risk that cost savings due to

[8] PD, p. 41 (emphasis added)
[9] Id., fn. 53 (emphasis added).
[10] The PD claims that under a WRAM a utility can still earn above their authorized ROE. (Id., p. 39.) It offers no support for this statement, which makes little sense given the nature of the WRAM.

conservation will not be passed on to customers until the next general rate case. The PD, however, ignored the fact that in some ways the WRAM and MCBA will leave the customers better off (and the utility worse off) than before. The failure to consider this aspect of the WRAM and MCBA is a significant flaw that undermines the validity of the PD's ROE reduction analysis.

c. The PD Ignores the Significant Risks Not Addressed by the WRAM or MCBA

Because it does nothing to reduce the possibility that the CPUC may allow or disallow recovery of investment or expenses, the WRAM and MCBA do not reduce regulatory risk. According to DRA, "the business risk of a regulated utility consists primarily of regulatory risk."[11] "Regulatory risk" exists when the possibility that a regulator will disallow an investment or expense is greater than the possibility that the regulator will allow recovery of excess investment or expenses.[12] The WRAM and MCBA focus on the California American Water's authorized costs, which may be significantly less than its actual costs due the vagaries of the regulatory process. These risks are significant and are improperly ignored by the PD's ROE reduction.

Additionally, the PD claims, "There is a substantial reduction in business risk for a water utility to have in place regulatory mechanisms that ensure the utility will consistently recover all … water supply costs, regardless of sales."[13] The proposed WRAM and MCBA, however, do not ensure recovery of <u>all</u> water supply costs. Water supply costs such as operations costs for source of supply, production and water treatment (including chemicals) are not included in the WRAM or MCBA.[14] Therefore, to the extent the ROE reduction was based on the misconception that California American Water will be ensured recovery of all water supply costs, it should be rejected.

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[11] Exh. 37, p. 3-1.
[12] Exh. 12, p. 21.
[13] PD, p. 39.
[14] Exh. 48, p. 3.

2. To the Extent the WRAM is Relevant to the Investors it Will Be Addressed by the Market

The PD mistakenly jumps to the conclusion that the CPUC must artificially reduce California American Water's ROE to account for the risks affected by the WRAM and MCBA. The PD does not stop to consider whether the WRAM and MCBA are relevant to investors or whether the market will make its own adjustment for the WRAM and MCBA.

a. The WRAM Reduces Risks that Do Not Affect the Cost of Equity

The PD claims, without offering any evidentiary support, that "A WRAM ratemaking mechanism is very attractive for an equity investor in water utilities."[15] The PD's ROE reduction analysis is based on the incorrect assumption that the risks decreased by the WRAM are risks that affect the cost of equity. This demonstrates a lack of understanding of the difference between systemic and unique risk, one of the most basic and widespread concepts in financial theory.

Investors only expect to be compensated for systematic risk, also known as "market" risk that threatens all businesses, such as changes in interest rates, inflation, and general business cycles. Investors expect a return for bearing systemic risk; therefore it affects the cost of equity. By contrast, unique risk is risk that can be eliminated by portfolio diversification. Unique risks are peculiar to a specific industry, individual company, or investment project. Such factors would include, among other things, threats of competition, specific capital projects, or even the utility's particular rate design. Indeed, it is important to note that even weather risk is normally a diversifiable risk (i.e., investors can avoid it). Investors who hold diversified portfolios do not require a return for bearing unique risk; therefore, it does not affect the cost of equity.[16]

The WRAM addresses unique risks, such as rate design and fluctuating sales due to conservation or weather, which <u>are not</u> relevant to the cost of equity. It does not address

[15] PD, p. 39.
[16] Exh. 46, p. 9.

systemic risks, which are relevant to the cost of equity. Therefore the CPUC should reject the PD's ruling that implementation of the WRAM justifies a reduction in ROE.

3. The PD's ROE Reduction is Inconsistent with the Concept of a Reasonably Efficient Capital Market

As discussed in more detail below, the PD relies heavily on the discounted cash flow ("DCF") method to determine California American Water's initial ROE. The PD conveniently abandons the DCF concepts, however, when it reduces the ROE due to the WRAM. There is no need to make a downward adjustment for the WRAM, because the market will address it. Reducing California American Water's ROE to account for factors already reflected in a market-based cost of equity estimate is tantamount to double-dipping.

The concept of an efficient market, which is inherent in the DCF model, states that the market prices of regularly-traded financial assets reflect all publicly-available information, and adjust fully and quickly to new information.[17] This concept of the efficient market is the cornerstone of the DCF method and thus a cornerstone of the PD's ROE analysis, as discussed in more detail in the section addressing the PD's underlying ROE analysis below. All publicly-available information regarding the growth of future cash flows is reflected in the current stock price component of the DCF formula. To the extent any publicly available information is relevant to the rate of return demanded by investors (the cost of equity); it too is reflected in that stock price. Therefore, even assuming for the sake of argument that the factors affecting revenue variation for water utilities are indeed systematic, reducing the ROE to account for a mechanism designed to reduce that variation would be double counting – the information is counted once through the use of a utility-based sample group, and then again by the proposed ROE reduction.[18]

C. CPUC Case Law Does Not Support the ROE Reduction

Contrary to the claims in the PD, the CPUC caselaw on revenue adjustment

[17] Exh. 46, p. 16.
[18] Id., pp. 16-17.

mechanisms for energy and water utilities does not support a downward adjustment in California American Water's ROE if the WRAM and MCBA are adopted. The PD falsely claims that when the CPUC implemented revenue adjustment mechanisms in the past it "explicitly reflected this risk reduction in each utility's ROE."[19] In fact, the CPUC did nothing of the sort. The ALJ misinterprets and misrepresents the holdings in the cases cited in the PD, and incorrectly dismisses the most relevant precedent as an exception. This flawed legal analysis presents no basis for the CPUC to reduce California American Water's ROE and should be rejected.

The PD's claim that the CPUC explicitly reflected revenue adjustment mechanism risk reductions in adopted ROEs is simply untrue. To support its claim, the PD first cites D.88835, which adopted a supply adjustment mechanism ("SAM") to recover the loss or gain in gas sales.[20] While this decision indicates that the possible reduction of risk will be considered in future rate of return analyses, it certainly does not explicitly provide a risk reduction in a utility's adopted ROE.

In the next decision cited in the PD, D.93887, the CPUC adopted the ERAM for Pacific Gas and Electric Company ("PG&E").[21] The PD quotes the vague statement in that decision that the adopted ROE "gives consideration" to the ERAM, but this statement certainly does not show that the CPUC made a specific downward adjustment for the ERAM. Equally important, the CPUC in this case determined the relevance of the risk reduction from the ERAM in the context of the overall rate of return, not in isolation.

Next the PD turns to D.93892, in which the CPUC adopted the ERAM for San Diego Gas and Electric Company ("SDG&E").[22] In that case, the CPUC's ROE analysis was dominated by concerns about investor's perceptions of SDG&E. As shown in the lengthy quote in the PD, the CPUC mentioned the ERAM in passing, but certainly did not explicitly reflect the

[19] PD, p. 34.
[20] *A supply adjustment mechanism (SAM) established to provide natural gas utilities the opportunity to recover the test year level of gas margin*, D. 88835, (1978) 84 CPUC 2d 5.
[21] *PG&E Co.*, D.93887, (1981) 7 CPUC 2d 349.
[22] *SDG&E Co.*, D.93892, (1981) 7 CPUC 2d 584.

ERAM's risk reduction in the ROE.

When the CPUC adopted an ERAM for Southern California Edison Company ("SCE") in D.82-12-055, it noted the ERAM but ended up granting SCE a 16% ROE, an all-time high.[23] Finally, in the most recent implementation of revenue adjustment mechanisms for energy utilities, directed by Pub. Util. Code. §739.10, the CPUC chose not to adjust ROE for the ERAM.[24]

CPUC caselaw does not show a history of explicit revenue adjustment mechanism risk reduction in ROE. At best, the decisions cited in the PD make references in dicta to risk reduction from the SAM or ERAM, but do not include findings of fact showing a correlation between ROE and decoupling or provide any basis for making a numerical calculation to adjust ROE. The most recent implementation of revenue adjustment mechanisms does not address a correlation between decoupling and ROE at all. Therefore, contrary to the PD's misleading claims, CPUC caselaw does not provide any directive to the CPUC to reduce California American Water's ROE in this proceeding.

D. The ROE Reduction Works Against the CPUC's Conservation Goals

The ROE reduction set forth in the PD will punish California American Water for implementing a conservation rate design. This directly contradicts the goals of the CPUC's Water Action Plan, in which the CPUC committed to increase water conservation and remove disincentives for water utilities to encourage conservation. As the PD correctly notes, the purpose of the WRAM is to remove the disincentive associated with conservation by decoupling water utility sales from earnings.[25] As discussed above, the WRAM offsets some of the risks associated with conservation rate design and brings the utility back to its current level of risk. That benefit, however, is cancelled out by the ROE reduction in the PD, leaving the utility in a worse position than before it implemented conservation rate design. If the CPUC adopts the PD,

[23] *SoCal Edison Co.*, D.82-12-055 (1982) 10 CPUC 2d 155.
[24] *Application of Southern California Edison Company*, D.02-04-055, (2002) 2002 Cal. PUC LEXIS 285.
[25] PD, p. 31.

it will be sending a signal to water utilities that they will be punished if they implement conservation rate design. This hardly furthers the CPUC's conservation objectives and goals.

In summary, the PD's recommendation that the CPUC reduce California American Water's ROE if it implements a WRAM is premature and unsupported by record evidence. This is the first time the CPUC has considered a ROE reduction linked to the implementation of a conservation rate design WRAM and it is inappropriate to address such a far-reaching policy issue in a rate case proceeding for a single utility. Even if the issue of the ROE reduction was timely, fully addressed in the record, and appropriately considered in this proceeding, the conclusions set forth in the PD are based upon incorrect and flawed assumptions that run contrary to established financial principles. Additionally, contrary to the PD's claims, CPUC case law does not support the ROE reduction. Finally, reducing a utility's ROE because it adopted a conservation rate design WRAM will discourage that utility from pursuing conservation, contrary to the CPUC's Water Action Plan.

III. THE PD'S RETURN ON EQUITY ANALYSIS IS SERIOUSLY FLAWED

Not only does the PD err in recommending a ROE reduction tied to the WRAM, but the recommended ROE was too low even before the WRAM-related reduction, mainly due to the rejection of California American Water's proposed leverage adjustment. The PD's ROE analysis is rife with factual and legal errors and improperly disregards California American Water's financial risk. The CPUC should delete this portion of the PD and replace it with language recognizing the need for a leverage adjustment for California American Water.

A. The CPUC Cannot Rely on the PD's ROE Analysis Because it is Riddled with Factual and Legal Errors

The CPUC cannot adopt the PD's recommended ROE because the underlying analysis contains a multitude of factual and legal errors. These errors undermine the validity of the PD's suggested ROE, in particular its rejection of a leverage adjustment for California American Water. California American Water will address these errors below in the order in which they appear in the PD.

First, the PD omits the fact that California American Water performed two capital asset pricing model ("CAPM") analyses. The PD correctly notes that one CAPM analysis yielded a ROE of 12.1%.[26] The PD completely fails to mention, however, that California American Water performed a second CAPM analysis that yielded a 10.8% ROE.[27] This is relevant because, as discussed below, the PD bases its dismissal of the CAPM on a factual error and should have properly included the results of these analyses in is ROE calculation.

Second, the PD misstates the commitment of California American Water's parent RWE to pass on cost of capital savings to customers. The PD states that RWE agreed to "pass through all cost of capital savings to ratepayers."[28] Review of the RWE decision, D.02-12-068, however, reveals that RWE committed only to pass on cost of capital savings that were not related to the Citizens acquisition.[29] To the extent that the PD chose not to adopt a leverage adjustment because of this commitment, this clarification is important.

Third, the PD improperly uses a settlement as precedent. The PD cites D.06-11-050 as precedent for its finding that DRA's models are reasonable.[30] That decision, however, approved a settlement between DRA and California American Water on this issue. As the ALJ should be well aware, the CPUC's rules state that settlements cannot be used as precedent for subsequent cases. Rule 12.5 states, "Unless the Commission expressly provides otherwise, such adoption does not constitute approval of, or precedent regarding, any principle or issue in the proceeding or in any future proceeding." Since the CPUC made no such express provision in D.06-11-050, the PD language regarding the reasonableness of DRA's models should be deleted.

Fourth, the PD incorrectly states that California American Water's CAPM

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[26] PD, p. 25.
[27] Exh. 7, p. 30.
[28] PD, p. 26 (emphasis added).
[29] *Joint Application of California-American Water Company (U-210-W), et al.*, D.02-12-068, (2002) 2002 Cal. PUC LEXIS 909, *89.
[30] PD, p. 26; *see Application of California-American Water Company*, D.06-11-050, (2006) 2006 Cal. PUC LEXIS 479.

included natural gas distribution utilities.[31] To the contrary, California American Water explicitly stated that it had selected the seven publicly-traded water utilities for its cost of equity analysis. It did not, as the PD states, include gas utilities in its analysis. The PD's sole basis for its dismissal of California American Water's CAPM is the alleged use of gas utilities. The PD states, "We do not rely on the CAPM model as Cal-Am includes natural gas distribution utilities."[32] The PD cites two previous decisions, D.06-11-050 and D.03-02-030 that also reject the CAPM, also solely on the basis that California American Water included gas utilities. Since California American Water did not use gas utilities in its CAPM in this rate case however, its results should be considered as part of the ROE analysis.

Fifth, the PD improperly refers to stale data from a previous decision to imply that California American Water regularly overearns. The PD refers to D.04-05-023, which discussed California American Water's history of overearning.[33] The PD fails to note, however, that overearning referred to in that decision was mainly due to being allowed to collect deferred balancing account balances. Nor does the PD provide citations to any more recent data. It is improper for the PD to use data from a 2002 application, data that is not even part of the record in this proceeding, to support its analysis.

Sixth, the PD erroneously states that California American Water's shareholders are "already rewarded for a lower equity ratio for the amortization of the Citizens premium."[34] The PD fails, however, to provide a citation to the Citizens decision supporting this statement. Shareholder rewards for a lower equity ratio are not part of the recovery of the Citizens acquisition premium.[35]

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[31] PD, p. 27.
[32] Id.
[33] PD, p. 28, *see Application of California-American Water Company*, D.04-05-023, (2004) 2004 Cal. PUC LEXIS 234.
[34] PD, p. 30.
[35] Id.; *see generally Application of Citizens Utilities Company of California (U-87-W), a California Corporation, and California-American Water Company*, D. 01-09-057, (2001) 2001 Cal. PUC LEXIS 826. This error was apparently not corrected before the CPUC adopted a similar finding in D.06-11-050. (2006 Cal. PUC LEXIS 479, p. 27.) All the more reason to correct it in this decision, however, so that the error will not be propagated further.

Seventh, the PD alleges that California American Water claimed in the RWE merger proceeding that the merger would provide "significant benefits to ratepayers from savings on cost of capital, specifically from increased leverage."[36] This is incorrect. In the RWE proceeding, California American Water made no mention of benefits from increased leverage. In fact, California American Water limited its discussion of cost of capital benefits to savings related to cost of debt. Finding of Fact 12 of the RWE decision recognizes this, stating, "Cal-Am ratepayers will benefit from this transaction because Cal-Am will have a lower cost of debt and cost of capital as a result of the transaction."[37] Benefits from lower cost of debt and benefits from increased leverage are two different things, and only the former was addressed in the RWE decision.

The sheer multitude of legal and factual errors, most of them dealing with material issues, undermines the validity of the PD's ROE analysis. The CPUC would do a grave disservice to the regulatory process if it were to reply upon and adopt such an analysis.

B. The PD Improperly Accounts for California American Water's Financial Risk

Even if the PD's ROE analysis were free of the factual and legal errors above, its conclusions would still be invalid because it improperly accounts for California American Water's financial risk. First, the PD incorrectly states that California American Water is not riskier than comparable water utilities. Second, the PD erroneously claims that California American Water's leverage ratio does not warrant an upward leverage adjustment. Third, the PD's failure to adopt the leverage adjustment violates the legal standard for rates of return.

[36] PD, p. 30 (emphasis added).
[37] D.02-12-068, 2002 Cal. PUC Lexis 909, *82 (emphasis added). As with the previous error, this error also was adopted uncorrected in D.06-11-050. (2006 Cal. PUC LEXIS 479, *27.) As with the previous error it should be corrected in this decision to avoid further propagation.

1. The PD's Claim that California American Water is Not Riskier Than Comparable Water Utilities is Contradicted by the Record and Basic Finance Theory

The PD incorrectly states, "Cal-Am [is] not riskier than comparable utilities."[38] The PD provides no analysis to support this statement, nor does it cite to any supporting evidence. The record in this proceeding, however, contradicts the PD's claim regarding California American Water's financial risk.

Both California American Water and DRA agree, as does basic finance theory, that if two companies are similar in terms of business risk (for example, two CPUC-regulated Class A water utilities), investors will require a higher return for investing in the company (or water utility) that has more debt.[39] Increased debt means increased financial risk, which requires a higher return on equity to attract investment. The proxy companies used in the PD's analysis had higher equity ratios than California American Water.[40] Both California American Water and DRA agreed that this means that California American Water's financial risk is higher than the proxy companies.[41] Despite this evidence, however, and flying stubbornly in the face of common sense, the PD maintains that California American Water does not have a higher financial risk.

Because the PD wrongly concludes that increased debt does not result in increased financial risk, and because the PD fails to recognize the difference between California American Water's financial risk and that of the proxy companies, the PD finds that California American Water's leverage ratio "does not warrant an upward leverage adjustment to the ROE."[42] Obviously, since it is based on the incorrect conclusions discussed above, the PD's finding regarding the necessity of the leverage adjustment is also incorrect.

If the proxy companies used in the ROE analysis had debt/equity ratios

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[38] PD, p. 30.
[39] RT 389-391, 393, 398 (Reiker/CAW); 491:12-13 (Hoglund/DRA).
[40] RT 490 (Hoglund/DRA).
[41] Id.
[42] PD, p. 31.

comparable to California American Water, an upward adjustment would not be necessary. Since, however, the record shows that California American Water's debt/equity ratio is significantly higher, this increased financial risk must be recognized in the ROE. The sample water utilities have the same business risk but less financial risk than California American Water, therefore California American Water must have a higher cost of equity. Any estimate of the cost equity which relies on market data for the sample water utilities must be adjusted to reflect the financial risk associated with California American Water. The fact that increased debt adds to the risk and required return on equity makes examination of the relative difference in the capital structures of the sample and subject companies, and adjustment of the cost of equity, equally as important as the selection of the original sample itself. If capital structure is not considered when the allowed return on equity is established, companies that are otherwise very similar end up with different returns on investment. Ignoring differences in capital structure results in unequal treatment of similarly situated companies

2. The PD Violates the Legal Standard for Rates of Return

The PD cites to *Bluefield*[43] and *Hope*[44] as setting forth the legal standards for rates of return. In calculating its recommended ROE, however, the PD failed to meet the standards set forth by the United States Supreme Court in those cases. The CPUC must correct this legal error before issuing a final decision in this proceeding.

a. The PD Does Not Meet the Comparable Earnings Standard

In setting a rate of return, the CPUC must consider the "comparable earnings standard" set forth by the Supreme Court in *Bluefield*. The comparable earnings standard states that the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.[45] The comparable earnings standard has come to be interpreted as the rate of return investors expect when they purchase equity shares of comparable

[43] *Bluefield Water Works & Improvement Co. v. Pub. Service Comm. of the State of Virginia* (1923) 262 U.S. 679.
[44] *Federal Power Comm. v. Hope Natural Gas Co.* (1944) 320 U.S. 591.
[45] *Bluefield*, 262 U.S. at 692-693; *Hope*, 320 U.S. at 603.

risk.[46]

As noted above, the PD relied on market data for a sample of publicly-traded water utilities to estimate the cost of equity. While these sample companies are likely to face business risk that is similar to California American Water, they have a significantly lower amount of debt in their capital structures, and therefore have significantly lower financial risk. Under the comparable earnings standard, if two companies are similar in terms of business risk, investors would expect a higher return for investing in the firm that has more debt.

When it estimated the cost of equity for California American Water, the PD completely ignored this difference in risk. The PD simply applied its sample group cost of equity estimate to California American Water without making any adjustment to reflect the undisputed fact that California American Water has a higher cost of equity than the sample. The PD's analysis therefore does not meet the comparable earnings standard.

b. The PD Harms California American Water's Financial Integrity and Capital Attraction

The PD's recommended ROE also violates the standards of financial integrity and capital attraction as set forth by the Supreme Court in *Bluefield* and affirmed in *Hope*.[47] According to *Bluefield* and *Hope*, a utility is entitled to a return that will allow it to maintain its credit so that it continues to have access to the capital markets to raise the funds necessary for investment. The PD violates this principle. This is because investors, realizing that an investment in California American Water does not offer a reward commensurate with its risk, in accordance with the most fundamental investing principles, would pull their money out of California American Water and invest it in any number of assets that offer a fair return. The PD attempts to show that California American Water has the ability to attract capital for necessary investment by citing the credit rating of American Water Capital Corporation ("AWCC").[48]

[46] Exh. 3, p. 12, n. 3.
[47] *Bluefield*, 262 U.S. at 693; *Hope*, 320 U.S. at 603-605.
[48] PD, p. 29.

However, the credit worthiness of AWCC is supported by the earnings of subsidiaries in multiple states. Neither the PD nor the record offers an analysis or study of the creditworthiness of California American Water on a standalone basis. Instead, PD simply assumes that American Water will continue to invest in California American Water at a loss indefinitely. This is not true. American Water can and does control where it will invest its money. In the past, it has reduced investment in certain states because of low authorized returns. Failing to take such a consequence into account is yet another example of the shortsightedness of PD's recommendations in this case.

IV. THE PD MISCHARACTERIZES AND UNNECESSARILY MODIFIES THE ISRS PROGRAM

As with the ROE reduction for the conservation rate design WRAM, the ISRS program as modified by the PD would actually leave California American Water in a worse position than it is now. Once again, the PD has punished California American Water for seeking to advance the objectives of the Water Action Plan. Instead of increased regulatory flexibility, the PD ISRS program will only provide additional administrative headaches. The ISRS set forth in the PD will not advance Water Plan objectives, nor would other utilities consider it a model to emulate. If the CPUC is seeking to send a message that it is "strengthening long term capital asset planning for a water utility, with specific emphasis on ensuring an adequate level of new investment for the routine replacement and upgrades that are necessary to maintain adequate water service,"[49] as the PD claims it is, adopting the modifications set forth in the PD is not the way to do it.

A. The PD Mischaracterizes California American Water's ISRS Proposal

The PD is replete with mischaracterizations and factual errors regarding California American Water's ISRS proposal. As some of these mischaracterizations and errors are the basis for the PD's needless modifications to the ISRS program, it is worth addressing

[49] Id., p. 52.

them here.

First, the PD mischaracterizes California American Water's statements regarding the need for the ISRS program. The PD declares that California American Water's "identified need for infrastructure replacement is easily met within our existing ratemaking process."[50] In support of this statement, the PD notes that the "record does not show that Cal-Am has experienced any disallowances in its Los Angeles District."[51] These statements, however, are misleading for several reasons. California American Water made its traditional substantial upfront showing for all of its projects in the rate case, even projects that would fall under the ISRS program. California American Water did so because it did not know whether the CPUC would adopt the ISRS program. These projects were then thoroughly reviewed by California American Water and were the subject of lengthy settlement negotiations. It is inefficient, however, to expend this level of resources on ISRS projects, which are routine replacements of existing infrastructure. The ISRS program is needed to maximize the efficiency of the process. Additionally, the PD makes the flawed assumption that since there are no current problems, there is no need to implement ISRS. The reason there is no evidence of future problems the GRC, is because without ISRS, there is no reason to re-evaluate, prioritize and expand spending for infrastructure replacement above historical levels. That is the whole point of proposing a change in current regulation. Finally, the PD fails to note that the California American Water witness also testified that despite following a detailed and rigorous planning process, managing actual capital expenditures sometimes requires delaying infrastructure replacements. ISRS will minimize this problem.

Second, the PD takes statements by a California American Water witness out of context to allege that California American Water is seeking to remove regulatory risk by assuring full rate recovery without later reasonableness review.[52] Nothing could be further from the truth.

[50] Id., p. 48.
[51] Id., p. 49.
[52] Id.

Throughout this proceeding, California American Water has argued that its ISRS program will provide enhanced regulatory oversight, in particular because it will provide increased reasonableness review after projects are completed.[53] As the record shows, capital projects currently receive intense CPUC review at the planning and proposal stage. This helps assure the CPUC that the costs for the proposed projects are reasonable. After projects are completed and put into ratebase, however, there is no review to determine whether the costs for the actual projects, as constructed, were reasonable. Under the ISRS program, the most meaningful review would take place after the project is completed. This would mean that the parties would have actual data, rather than estimates, and would be able to review the actual project, not just a proposal. Contrary to its characterization by the PD, this enhanced oversight is one of the reasons California American Water so strongly supports the ISRS program.

Third, the PD wrongly states that the benefits of an ISRS program, i.e., the fact that customers would not pay for a project until it is completed, are already provided by advice letters. This is factually incorrect. Advice letter projects and ISRS projects are not comparable. Advice letters are usually reserved for large complex projects that have a level of uncertainty regarding timing or costs. By contrast, ISRS projects are routine replacements of existing infrastructure, usually in smaller in scale, scope and costs. There is currently no ratemaking mechanism in place that provides all of the benefits of ISRS, including delaying implementation of rate increases, an ongoing level of new investment for routine infrastructure replacements and upgrades, and a separately identified revenue stream for infrastructure investment.

Fourth, the PD incorrectly claims that California American Water has proposed to "delink its level of infrastructure investment from its own asset management plan, the [Comprehensive Planning Study, or] CPS."[54] California American Water has made no such proposal. The record demonstrates that California American Water indicated that the CPS does

[53] Exh. 13, p. 24.
[54] PD, p. 52.

not include replacement projects due to age and that it is unlikely future CPS reports would do so.[55] Rather, as California American Water repeatedly stated, it would undertake a comprehensive review and analysis of infrastructure replacement and upgrade needs for use in future case once the ISRS is approved.

Fifth, the PD speciously claims that replacing the lengthy and resource-intensive prospective review of infrastructure replacement projects with an in-depth after the fact review of actual projects, with the potential for disallowances of unreasonable costs, is somehow "inconsistent with our regulatory objectives."[56] The PD declines to identify either the inconsistencies or the regulatory objectives. In truth, after the fact review and disallowances are commonplace under the current regulatory scheme. For example, the CPUC may order a utility to track the costs of a particular project in a memorandum account. Once the project is complete, the CPUC has the opportunity to review the project costs for reasonableness and disallow certain costs if necessary. Similarly, advice letter projects, which the PD says provide comparable benefits to ISRS, also allow for after the fact review and disallowances. Moreover, far from being inconsistent, California American Water's proposed ISRS program furthers the Water Action Plan regulatory objectives of promoting infrastructure investment and streamlining CPUC regulatory decision making.

The PD's factual inaccuracies, misinterpretations and misleading statements undermine the validity of the record in this proceeding. The CPUC must correct these inaccuracies before it issues a final decision regarding the ISRS program.

B. The PD's Modifications Defeat the Purpose of the ISRS Program

In the name of "effective regulatory oversight" the PD modifies the ISRS program to the point that instead of streamlining the CPUC process, it provides significant additional administrative burdens. The pre-approval process described in the PD is actually more

[55] RT 287: 2-19 (Valladao/CAW).
[56] PD, p. 53.

burdensome than the current process. Additionally, the Tier 3 Advice Letter process would remove administrative efficiencies and increase the potential for delayed recovery in rates. Moreover, even if California American Water or another utility wanted to use the ISRS program as a model, the PD includes that language the appears to unnecessarily limit an ISRS pilot program to California American Water's Los Angeles District. Adoption of the PD's version of the ISRS program will send the strong signal to water utilities that the reward for making innovative proposals to further the goals of the Water Action Plan is increased regulatory burdens and resource expenditures.

1. The PD's Pre-Approval Process for ISRS Programs is More Burdensome than the Current Process

The pre-approval process for ISRS set forth in the PD is provides more burdens and fewer benefits than the current regulatory process. For example, the PD recommends that the CPUC require:

> [L]ong term capital asset management planning, to include the development of an infrastructure replacement strategy, and [review of] these plans and underlying detailed cost estimates in a GRC proceeding prior to Cal-Am commencing construction projects. We should then set a dollar cap on the surcharge based on our planning review….Cal-Am will have flexibility within this cap to reprioritize or add projects, and to shift authorized funding between projects, provided it continue to follow its existing internal project review process and submits supporting documentation to the Commission at the time it requests new or revised projects to be included under the surcharge.[57]

These requirements are more rigorous than the current regulatory process. For example, in this GRC, California American Water was able to get approval for infrastructure replacement at a level of 7% of annual revenues based on its normal GRC showing, even though it is absent a formal long-term infrastructure replacement strategy. Moreover, since the CPUC approves the level of expenditure, not the underlying projects, California American Water currently has the ability to reprioritize or add projects and to shift funding between projects

[57] Id., p. 55. Additionally, the PD's surcharge proposal is unclear. The PD recommends a surcharge cap of 7% of annual revenues for this GRC, but is unclear whether that is 7% per year or 7% over the GRC period.

without submitting supporting documentation. Additionally, unlike the ISRS program, California American Water can begin recovering the costs of these projects in rates even before they are completed.

Since these modifications increase burdens while decreasing flexibility, they provide no incentive for California American Water or any other utility to further infrastructure investment through the ISRS program.

2. Imposition of the Tier 3 Advice Letter Process Removes the Administrative Efficiencies Created by the ISRS Program

The PD argues, "Effective regulatory oversight requires that Cal-Am submit its infrastructure surcharge requests under our advice letter procedure that requires a formal Commission resolution."[58] As the PD admits, this Tier 3 advice letter process would not provide the expedited review and approval in California American Water's original ISRS proposal, but rather would include notice to all interested parties, a full protest period, and a formal CPUC resolution for adoption. Additionally the PD's modifications have the potential to delay implementation of ISRS surcharges for expenditures until long after the replacement property is already providing improved service to the customers. Since the CPUC already allows rates to be implemented for forward-looking capital expenditures as well as construction work that is still in progress, delaying the implementation of surcharges to recover additional capital costs for construction projects that are actually completed and placed in is actually a step backward in California regulation.

If the CPUC believes that additional oversight requires a more robust review than provided in California American Water's original ISRS program, California American Water proposes that the CPUC adopt a process to implement "interim" ISRS surcharges within 15 days of filing the advice letters. The parties could then continue with the "extensive review" envisioned in the PD and make adjustments to subsequent ISRS surcharges as needed. A similar

[58] Id. This is designated a Tier 3 filing.

procedure for adjusting subsequent ISRS-type surcharges is already in place in Pennsylvania, although the initial surcharges are not labeled "interim."

The PD's modification turns the ISRS program into business as usual, just in a different package. It certainly does not send a "strong signal" of to the investment community of the CPUC's commitment to supporting new infrastructure investment. If the CPUC does not reject the modifications set forth in the PD, it will doom the ISRS program to failure before it starts.

V. CONCLUSION

For all of the foregoing reasons, California American Water respectfully urges the CPUC to modify the PD as discussed and to adopt the proposed findings of fact and conclusions of law in Appendix A.

Dated: May 29, 2007

Respectfully submitted,

STEEFEL, LEVITT & WEISS
A Professional Corporation

By: */s/ Lori Anne Dolqueist*
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APPENDIX A

Revised Findings of Fact

15. A ROE of ~~10.0%~~ **11.6** in this phase is reasonable based on the record and is fair because the return is commensurate with the returns on investment in comparable companies and is sufficient to (a) assure confidence in the financial integrity of Cal-Am, (b) maintain its credit, and (c) attract necessary capital.

16. A leverage adjustment for Cal-Am's ROE is ~~not~~ warranted.

17. The **impact of the** adoption of a WRAM and/or MCBA in Phase 2 would ~~substantially~~ reduce **on** Cal-Am's business risk and ~~should be accompanied by~~ a ~~concurrent~~ **possible** reduction in ROE **should not be decided in this proceeding. We defer this issue to the Commission's Conservation OII proceeding**.[59] ~~We find that a .50% ROE adjustment is reasonable based on the record.~~

18. ~~While~~ **Timely** infrastructure replace is an important part component of responsible utility manage and DSICs are useful in some circumstances to fund infrastructure replacement~~,~~**.** Cal-Am has ~~not~~ established a need for its proposed ISRS.

19. There are **not** substantial risks to ratepayers in adopting the proposed ISRS, and the record provides strong evidence of this for the Los Angeles District.

20. We should ~~not~~ adopt Cal-Am's proposed ISRS.

21. ~~There are benefits to adoption of a DSIC and we should consider adoption of a pilot program provided we adopt effective regulatory oversight mechanisms.~~

Revised Conclusions of Law

7. ~~Our case law for energy and water utilities reflects that the Commission has consistently held that implementation of a revenue adjustment mechanism does reduce business risk and this reduction in risk should be explicitly reflected in a downward adjustment to ROE.~~

8. We should adopt as a pilot program for this GRC period ~~a DSIC as follows~~ **Cal-Am's proposed ISRS:**

a. The surcharge should be based on the infrastructure projects **completed and placed into service during the period covered in the advice letter filing.** ~~reviewed and approved in this proceeding, identified in the Cal-Am/DRA settlement, and have a cap of 7% of annual adopted revenues for the test period. The dollar cap for 2007 is $1,323,588, and will be adjusted for 2008 and 2009 based on escalation factors~~.

b. Cal-Am should file by quarterly advice letter, ~~under the Tier 3 procedures specified in D.07-01-024~~, for its DSIC surcharge. **The surcharge will be implemented within 15 days of the advice letter filing.** ~~It should explicitly and clearly state in each~~

[59] Alternative: **We defer this issue to the upcoming combined cost of capital proceeding.**

~~advice letter filing, and provide supporting documentation, for (1) any project that was not approved in this GRC proceeding, and (2) any project that is included at an amount over the level authorized in this GRC proceeding~~.

~~e. In evaluating projects not included in this GRC review, Water Division should apply the following criteria: Does the expenditure contribute to an adequate ongoing level of new investment for the routine replacement and upgrades that are necessary to maintain adequate water service for customers? For these projects as well as authorized projects with final costs in excess of estimates found reasonable in the GRC, Cal-Am retains the same burden of proof to justify costs that we applied in our GRC review.~~

PROOF OF SERVICE

I, Cinthia A. Velez, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years and not a party to this action. My business address is STEEFEL, LEVITT & WEISS, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On May 29, 2007, I served the within:

Comments of California-American Water Company on
The Proposed Decision of Administrative Law Judge Walwyn

on the interested parties in this action addressed as follows:

See attached service list

☒ **(BY HAND SERVICE)** By causing such envelope to be delivered by hand, as addressed by delivering same to SPECIALIZED LEGAL SERVICES with instructions that it be personally served.

☒ **(BY MAIL)** By placing such document(s) in a sealed envelope, with postage thereon fully prepaid for first class mail, for collection and mailing at Steefel, Levitt & Weiss, San Francisco, California following ordinary business practice. I am readily familiar with the practice at Steefel, Levitt & Weiss for collection and processing of correspondence for mailing with the United States Postal Service, said practice being that in the ordinary course of business, correspondence is deposited in the United States Postal Service the same day as it is placed for collection.

☒ **(BY PUC E-MAIL SERVICE)** By transmitting such document(s) electronically from Steefel, Levitt & Weiss, San Francisco, California, to the electronic mail addresses listed above. I am readily familiar with the practices of Steefel, Levitt & Weiss for transmitting documents by electronic mail, said practice being that in the ordinary course of business, such electronic mail is transmitted immediately after such document has been tendered for filing. Said practice also complies with Rule 1.1 of the Public Utilities Commission of the State of California and all protocols described therein.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on May 29, 2007, at San Francisco, California.

/s/ Cinthia A. Velez
Cinthia A. Velez

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